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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

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JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
GARY PIERCE

AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF
GOLD CANYON SEWER COMPANY, AN
ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE OF
ITS UTILITY PLANT AND PROPERTY AND
FOR INCREASES IN ITS RATES AND
CHARGES FOR UTILITY SERVICE BASED
THEREON

DOCKET NO. SW-02519A-06-0015

NOTICE OF ERRATA

The Staff of the Arizona Corporation Commission ("Staff") hereby files the following
Errata to its Closing Brief filed January 19, 2007. The purpose of this Errata is to correct
grammatical, formatting, punctuation errors and two corrections of numbers. On page 1, line 14, of
Staff's brief \$10.3 is changed to \$11.2; page 33, line 17, 1 basis point is changed to 100 basis points.
The substance of the pleading has not been changed.

RESPECTFULLY submitted this 23rd day of January, 2007.

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Arizona Corporation Commission
DOCKETED

JAN 23 2007

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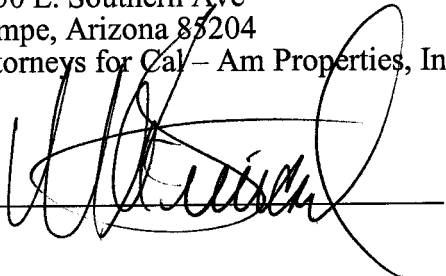
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A large, stylized handwritten signature in black ink, likely belonging to Mark Tucker, is written over a horizontal line. The signature is fluid and cursive, with a large loop at the end.

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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3 JEFF HATCH-MILLER, Chairman
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DOCKET NO. SW-02519A-06-0015

**ERRATA OF CLOSING BRIEF OF
COMMISSION STAFF**

16 Gold Canyon Sewer Company ("Gold Canyon" or "Company") filed an application for an
17 increase in its rates in the above captioned matter on January 13, 2006. The Company requests a rate
18 increase of approximately 93.14%.¹ The requested increase is mostly driven by approximately \$11.2
19 million of plant additions. The plant additions updated and expanded the Company's wastewater
20 treatment facility.²

21 The Company's current rates were authorized in Decision No. 64186, dated October 30,
22 2001.³ While the case was still pending, Algonquin Water Resources of America, Inc. ("AWRA")
23 purchased the stock of the Company from Shea Homes.⁴ Shortly after the purchase, the parties to the
24 case filed a settlement agreement on August 29, 2001 ("Settlement Agreement").⁵ The Settlement
25 Agreement provided that, "Staff and Intervenor's willingness to enter into this agreement is premised
26 in part on their belief that Applicant's recent change in ownership from a developer owned utility to a
27 separate investor owned utility will lead to improved operation of the Company."⁶

28 ¹ A-12 at 1, ll. 14-18.

² See A-8 at 2, ll. 19-22; See also TR 245:2-4; Note that Mr. Weber stated that the renovations cost \$10.3 million. Mr. Hernandez corrected the number. A-5 at 7, ll. 16-20.

³ S-18 at 3, ll. 12-14. *In the Matter of the Application of Gold Canyon Sewer Company for Adjustments to its Rates and Charges for Wastewater Utility Service*, Docket No. SW-02519A-00-0638, Decision No. 64186 (October 30, 2001).

⁴ A-5 at 3 (AWRA purchased the stock in August, 2001).

⁵ S-14 at 3, finding of fact 17.

⁶ S-14, Exhibit A at 1.

1 In the test year ending October 31, 2005, the Company provided wastewater services to 5,281
2 customers in the northeastern portion of Pinal County, east of the Town of Apache Junction.⁷ The
3 Company's service territory includes the communities of Gold Canyon and Peralta.⁸ The Company
4 experienced rapid growth during the period between the test year and the last rate case. The
5 Company had approximately 2,000 customers in its last test year.⁹ Although growth has slowed
6 down in the past year, the Company projected approximately 8,600 customers by year ending 2010 in
7 its Application.¹⁰

8 AWRA recently purchased the stock of a number of Arizona utilities. AWRA's
9 organizational structure is described in the introduction below. This rate case is the second rate case
10 filed by an AWRA utility in Arizona. The first rate case was filed by Black Mountain Sewer
11 Company ("Black Mountain Sewer") in Docket No. SW-02361A-05-0657. The Arizona Corporation
12 Commission (the "Commission") issued a decision for Black Mountain Sewer on December 6,
13 2005.¹¹

14 Many of the issues presented in this case are identical to the issues presented in the Black
15 Mountain Sewer case. Staff's legal arguments for those issues are the same as its arguments in the
16 Black Mountain Sewer case. Notwithstanding the similarities, Staff presents additional facts
17 discovered in this case to further support its legal arguments. There are no new facts or legal
18 arguments in this case to support different decisions than the decisions in the Black Mountain Sewer
19 case.

20 21 **I. INTRODUCTION.**

22 AWRA is a wholly owned subsidiary of Algonquin Power Income Fund ("APIF")
23 (collectively referred to as "Algonquin").¹² AWRA also owns and operates Black Mountain Sewer,
24

25 ⁷ S-1, Exhibit MSJ at 1.

26 ⁸ A-5 at 3, ll. 13-15.

27 ⁹ S-14 at 2, finding of fact 2.

28 ¹⁰ S-1, Exhibit MSJ at 4.

¹¹ *In the Matter of the Application of Black Mountain Sewer Corporation, An Arizona Corporation for a Determination of the Fair Value of Its Utility Plant and Property and for Increases in its Rates and Charges for Utility Service Based Thereon*, Docket No. SW-02361A-05-0657, Decision No. 69164 (December 6, 2006) ("Black Mountain Sewer case").

¹² A-5 at 3.

1 Litchfield Park Service Company ("LPSCO"), Rio Rico Utilities, Inc., and Bella Vista Water
2 Company, which are all located in Arizona.¹³ In Decision No. 68826, dated June 29, 2006, AWRA
3 purchased the water systems collectively known as the McLain Systems. AWRA transferred portions
4 of the McLain Systems to two newly formed companies, Northern Sunrise Water Company, Inc.
5 ("Northern Sunrise") and Southern Sunrise Water Company, Inc. ("Southern Sunrise"). AWRA
6 received conditional Certificates of Convenience and Necessity ("CC&N") for these new companies
7 in Decision No. 68826.

8 AWRA also owns and/or operates 4 utilities in Texas,¹⁴ 1 utility in Illinois, and 3 utilities in
9 Missouri.¹⁵ In each of these states, there is an added organizational layer with a state specific holding
10 company.¹⁶ The state specific holding companies appear to be subsidiaries of AWRA, and parents of
11 the utilities or owners of utility facilities. So far, AWRA has not created an Arizona specific holding
12 company.

13 AWRA, AWRA's utility subsidiaries, and Algonquin affiliates, use a unique organizational
14 model and operate unlike all other utilities in Arizona except one. Recently, Staff became aware that
15 Global Water Resources, Inc. ("Global Water") operates its subsidiary utilities in the same manner as
16 Algonquin. At a hearing on January 12, 2006, a Global Water representative provided testimony
17 about Global Water's organizational model.¹⁷ Global Water has not filed a rate case after it began
18 using the model. Company witness Mr. Greg Sorensen also testified that Global Water may use a
19 similar organizational structure.¹⁸

20 AWRA's organizational model and transactions between its utilities and affiliates present
21 significant difficulties for the Commission's regulation of the utilities. In the Black Mountain Sewer
22 case, Company witness Mr. Robert Dodds testified that AWRA created its utility organizational
23

24
25 ¹³ *Id.* at 1, ll. 13-20. See also S-3 at Chart F (AWRA's organizational chart).

26 ¹⁴ S-3.

27 ¹⁵ *Id.*

28 ¹⁶ *Id.*

¹⁷ See *In the Matter of the Applications to Transfer the Certificates of Convenience and Necessity and Assests*, Docket Nos. SW-03576A-06-0155, *et al.*, filed March 9, 2006 (Request to transfer the certificates and assets of two utilities owned by Global Water Resources, LLC to Global Water Resources, Inc.)

¹⁸ TR 334: 3-9.

1 model using its model for unregulated hydro assets.¹⁹ He testified that AWRA uses its unregulated
2 model for all of its regulated utilities in the United States.²⁰ AWRA's organizational model deviates
3 substantially from traditional utility models that use shared service centers.

4 In the present case, Company witness Mr. Greg Sorensen testified that Algonquin has only
5 filed one other rate case using its model. Mr. Sorensen testified that the case is still pending in the
6 state of Missouri.²¹ Company witness Mr. David Kerr also provided a new explanation for
7 Algonquin's organizational model.

8 Mr. Kerr explained that APIF operates its regulatory infrastructure similar to a real estate
9 investment trust (a "REIT").²² He testified that Canadian income funds such as APIF are operated
10 similarly to REITs in the United States. As described by Mr. Kerr:

11
12 . . .the mutual fund trust owns a group of revenue-generating assets, and it's often
13 managed by an outside firm. For instance, all REITS are managed by a third-party
14 outside firm or it could be related.

15 So, the management and operations, accounting services are provided outside of the
16 ownership of the assets, because assets are revenue-generated assets. And we apply
17 that same model, that same operating model to the utility business when we got
18 involved in the utility business in 2001.²³

19 Mr. Kerr admitted that he did not know of any REIT that owns regulated utilities.²⁴

20 In the utility industry in the United States, holding companies for regulated utilities typically
21 create shared service centers to take advantage of economies of scale. Economies of scale allow
22 utility services to be provided at a lower cost. Shared service centers provide only a portion of the
23 services necessary for the provision of utility service. Subsidiary utilities provide the remaining
24 portion directly through their own employees. Holding companies then allocate costs to each of their
25 subsidiary utilities on a pro-rata basis. In regulated industries, holding companies provide shared
26 services at cost.²⁵

27 ¹⁹ See Black Mountain Sewer case, Tr. 465, ll. 1-10, and 472, ll. 9-23.

28 ²⁰ *Id.*

²¹ TR 332: 3-11.

²² TR 1245:13-1247:1.

²³ *Id.* at 1246:13-22.

²⁴ TR 1261: 11-14.

²⁵ See S-28 and S-19 at 7, ll. 15-23.

1 AWRA's organizational model creates unnecessary layers of profits for its unregulated
2 affiliates in addition to allowed returns on equity ("ROE") for its utilities. The model captures
3 additional profits by creating shell utilities. Because utility subsidiaries have no employees, all utility
4 services must be provided through affiliates. Affiliate profits are then embedded in each utility's
5 cost-of-service and rate base.²⁶ Profits in cost-of-service are especially problematic. Under
6 traditional ratemaking principles, operating expenses are passed through to ratepayers without any
7 return.

8 Affiliate costs and profits in rate base also create problems for ratemaking. For affiliate costs
9 embedded in rate base, Algonquin would earn *two* rates of return on the same rate base – one for the
10 affiliate and one for the utility. More disturbing, a utility would also earn a return on the affiliate's
11 profit. The ratemaking effects of AWRA's extreme organizational structure can be illustrated with a
12 few examples.

13 Algonquin's unregulated affiliates provide almost all of the services required by each of its
14 utilities, including Gold Canyon Sewer.²⁷ For example, Gold Canyon Sewer has no employees and
15 does not operate its facilities.²⁸ Gold Canyon's sole shareholder, AWRA, also has no employees.²⁹
16 Algonquin Water Services ("AWS") provides employees to Gold Canyon, and is also the affiliate that
17 performs its utility operations.³⁰ Company witness Mr. Thomas Bourassa testified that AWS "was
18 *created for the purpose of providing operation and maintenance, engineering and construction,*
19 *financial and accounting, administration and management and customer relation services to the 15*
20 *water and sewer utilities owned by Algonquin.*"³¹

21 In addition to AWS, Gold Canyon Sewer receives services from Algonquin Power Systems
22 ("Algonquin Power") and Algonquin Power Trust ("APT").³² Algonquin Power "provides
23 professional services in the areas of health and safety, environmental compliance, engineering, and
24

25 ²⁶ See e.g. S-18 at 9, line 20-10, line 12 (capitalized affiliate profits); and at 23, line 20-24, line 10 (affiliate profits in
operating expenses).

26 ²⁷ See S-9 at RUCO 1.18, Schedule C (standard services included in contract) and Schedule D (excluded services).

27 ²⁸ TR 371:5-7. See also A-9 at 2, ll. 22-24.

28 ²⁹ TR 367: 8-11.

³⁰ A-5 at 1, ll. 10-12.

³¹ A-11 at 8, ll. 2-6 (emphasis added).

³² A-9 at 2, ll. 8-21. See also TR 344: 24 – 345: 2.

1 construction management.”³³ APT provides general corporate support.³⁴ Finally, unaffiliated
2 contractors provide services for specific projects.³⁵

3
4 Mr. Sorenson testified that Gold Canyon Sewer does not have written contracts with
5 Algonquin Power and APT.³⁶ Gold Canyon does have a written contract with AWS. Mr. Sorensen
6 testified that a written contract between AWS and Gold Canyon Sewer was negotiated between “the
7 CFO of the Power Income Fund and the general manager of the utility.”³⁷ The contract was executed
8 on January 1, 2004 by Peter Kampian on behalf of Gold Canyon Sewer, and by Robert Dodds on
9 behalf of AWS.³⁸ APIF’s website currently lists Mr. Kampian as the fund’s Chief Financial Officer
10 (“CFO”). It also lists Mr. Dodds as the Division Manager for Infrastructure.³⁹

11 Current filings at the Commission list Mr. Kampian as the Manager of AWS, and Mr. Dodds
12 as the President of Gold Canyon Sewer.⁴⁰ Mr. Sorensen also testified that Mr. Dodds had a different
13 “role in the Algonquin companies” in January, 2004.⁴¹ Apparently, Mr. Dodds became the President
14 of Gold Canyon Sewer in May of 2005.⁴²

15 The contract includes two types of fixed charges. First, beginning January 1, 2004, AWS
16 charges \$26,141.34 per month for direct operations. Second, also beginning January 1, 2004, AWS
17 charges \$3.00 per customer bill for customer service and accounting. The fee for direct operations
18 escalates 3% each year beginning on January 1. The fee for customer service and accounting
19 increased to \$3.25 on January 1, 2006, and escalates 3% each year beginning on January 1.
20 Paragraph C-2 in Schedule C, however, allows AWS and Gold Canyon Sewer to set a new budget for
21 operating costs each year.

22 The budget setting process has inherent conflicts of interest. It also does not result in changed
23 fees unless there are large profit surpluses or losses for AWS. Mr. Sorensen testified that he, Mr.

24 ³³ *Id.*

25 ³⁴ *Id.*

26 ³⁵ TR 336, ll. 19-21; and 1236, ll. 9-18.

27 ³⁶ TR 345: 1-10.

28 ³⁷ TR 329: 20-24.

³⁸ S-9, RUCO 1.18 at 1.

³⁹ S-6.

⁴⁰ S-5.

⁴¹ TR 401: 9-402: 3.

⁴² *Id.*

1 Dodds, and Mr. Charlie Hernandez represent AWS in the process.⁴³ Apparently, the same three
2 individuals also represent Gold Canyon Sewer in the process.⁴⁴

3 The budget submitted by AWS to Gold Canyon Sewer is reviewed and approved by Mr.
4 Kampian and Mr. Andrew Ingram on behalf of Algonquin Power Trust ("APT").⁴⁵ APT is the
5 Algonquin affiliate that provides "general management services including executive oversight,
6 strategic planning, legal, human resources, finance and accounting" to Gold Canyon Sewer.⁴⁶ APT
7 provides the services without a written contract for a fixed fee of \$4,000 per month.⁴⁷ The Company
8 asserts that APT's fee is at cost.⁴⁸

9 Despite the protections provided to the utility in Paragraph C-2, the budget process appears to
10 be a mere formality. Mr. Sorensen testified that the fixed fees would not change unless there are
11 "vast swings" in profits or losses for AWS.⁴⁹ He explained that swings of 4% or 8% would not
12 change the budget.⁵⁰

13 Data provided by the Company confirms Mr. Sorensen's testimony. In 2004, the budget
14 included a post-tax operating margin of 7.8%. AWS actually earned 14.01%.⁵¹ In 2005, the budget
15 included a post-tax operating margin of 8.0%. AWS actually earned 15.64%.⁵² Nevertheless, the
16 fixed fee for direct operations increased by 3% as provided in the escalation clause of the contract
17 (i.e. from \$26,141/month to \$26,926/month).⁵³

18 Staff urges the Arizona Corporation Commission (the "Commission") to regulate Gold
19 Canyon Sewer in the same manner that it regulates all utilities in Arizona. The Commission should
20 not allow the Company to evade ROE regulation by creating an organizational structure that
21 guarantees affiliate profits⁵⁴ in addition to allowed ROE.⁵⁵ As discussed below, Staff recommends
22

23 ⁴³ TR 370: 11-14.

24 ⁴⁴ *Id.* at 369: 19-25; see also *Id.* at 371, line 22 to 372, line 3.

25 ⁴⁵ *Id.*

26 ⁴⁶ A-9 at 2, ll. 18-20.

27 ⁴⁷ See S-9 (Price for Affiliate Transactions – 2004; CSB 2.37); see also A-9 at 4, line 23 to 5, line 7.

28 ⁴⁸ *Id.* (The schedule indicates that the "determined price" is at "cost."). See also A-9 at 2, ll. 20-21.

⁴⁹ TR 377: 20-378: 3.

⁵⁰ *Id.*

⁵¹ S-9 (Algonquin Water Services, LLC – 2004 Budget; CSB 2.37c).

⁵² *Id.* (Algonquin Water Services, LLC – 2005 Budget; CSB 2.37c).

⁵³ See footnotes 44 and 45.

⁵⁴ See S-19 at 5, ll. 1-5.

1 that the Commission disallow capitalized affiliate profit and affiliate profit embedded in operating
2 expenses.

3 Other disputes between Staff and the Company are also unresolved in this case. The parties
4 disagree on the appropriate ROE, the appropriate amount of affiliate overhead, and costs included in
5 operating expenses that should have been capitalized. There are additional differences based on the
6 underlying issues included in this brief. For example, even though Staff agrees with the Company on
7 the methodology for calculating property taxes, the amount of property taxes is different because of
8 differences in revenue requirement.

10 **II. AFFILIATE TRANSACTIONS**

11 **A. Capitalized Affiliate Profit And Affiliate Profit In Operating Expenses Should Be 12 Disallowed.**

13 Staff recommends that the Commission disallow capitalized affiliate profit in the amount of
14 \$67,449.⁵⁶ Staff's disallowance includes capitalized affiliate profit incurred in the years 2001, 2002,
15 2003, 2004, 2005.⁵⁷ Staff also recommends that the Commission disallow affiliate profit in the
16 amount of \$78,607, which was included in the Company's requested operating expenses.⁵⁸

17 Before addressing legal issues for affiliate transactions, Staff will first discuss discrepancies in
18 the Company's assertions about the profit margins it seeks. Mr. Sorensen testified that AWS targets
19 a "pre-tax profit of about 10%, . . .but the actual profit or loss varies month to month and year to
20 year."⁵⁹ In response to Staff data request CSB 2.37, the Company provided budgets for 2004 and
21 2005. The 2004 budget included a pre-tax target of 13.1% and a post-tax target of 7.8%. The 2005
22 budget included a pre-tax target of 13.3% and a post-tax target of 8.0%.

23 Therefore, the 2004 and 2005 budgets are inconsistent with Mr. Sorensen's testimony.
24 Additionally, the calculations appear to include an error. In calculating the profit margin, the
25 Company included a monthly cost for postage. Postage is recovered through Schedule A and not

26 ⁵⁵ *Id.* at 6, line 22 to 7, line 4 (Affiliate profits only serve to inflate ROE).

27 ⁵⁶ See Staff Brief Schedule CSB-7 (Rate Base Adjustment No. 3), page 1 of 2.

28 ⁵⁷ *Id.* 2 of 2.

⁵⁸ See Brief Schedule CSB-19.

⁵⁹ A-9 at 5, ll. 11-21.

1 through Schedule C.⁶⁰ The Company compared the costs to Schedule C fees. The error may have
2 occurred because the original contract did not include any fees for Schedule A.⁶¹ RUCO 1.18 (the
3 contract) also did not include a written amendment. Nevertheless, Staff assumes that the contract was
4 amended under paragraph B11.2.

5 Staff further assumes that postage is a pass through cost, and the Company is not earning a
6 profit margin on the cost. Accordingly, Staff removed the cost and recalculated the budgeted profit
7 margins. For 2004, the pre-tax profit margin in the budget becomes 17.8%. Assuming that the taxes
8 remain the same, the post-tax margin becomes 12.6%. For 2005, the pre-tax margin is 18.1%, and
9 the post-tax margin is 12.8%. The Company did not provide underlying data for actual profit
10 margins. Therefore, Staff does not know how the recalculation would affect the actual profit margins
11 reported by the Company.

12 State commissions have historically reviewed affiliate costs and profits with greater scrutiny
13 than other utility costs. Some example cases illustrate the review standard. But before examining the
14 review standard, an additional point must be made.

15 The review standard has been applied to limited affiliate transactions. Staff did not find one
16 decision (other than Black Mountain Sewer) in which a utility used the organizational model used by
17 Algonquin. The Company also could not identify any decisions directly on point.⁶² Mr. Sorenson
18 testified that AWRA has a case pending in Missouri in which the same model is used.⁶³

19 In *U.S. West Communications v. the Arizona Corporation Commission*, 185 Ariz. 277, 915
20 P.2d 1232 (App. 1996), the Arizona Court of Appeals held that the "Commission has broad powers to
21 scrutinize transactions between a regulated company and its unregulated affiliates" and disallow
22 excessive costs.⁶⁴ In *General Telephone Co. of Upstate New York v. the Public Service Commission*
23 *of New York*, 17 N.Y.2d 373 (N.Y. 1966), the Court of Appeals of New York held that:

24
25 When such materials and services are obtained through contracts which
26 are the result of arm's length bargaining in the open market, the contract

27 ⁶⁰ S-9 at Schedule A.

⁶¹ *Id.* at RUCO 1.18.

⁶² TR 332: 3-16; see also TR 1239: 6-20.

⁶³ *Id.*

⁶⁴ *Id.*, 185 Ariz. at 282, 915 P.2d at 1237 (citations omitted).

1 price is usually accepted as the proper cost. However, when a utility and
2 its suppliers are both owned and controlled by the same holding company,
3 the safeguards provided by arm's length bargaining are absent, and ever
4 present is the danger that the utility will be charged exorbitant prices
which will, by inclusion in its operating costs, become the predicate for
excessive rates.⁶⁵

5 Finally, in *Turpen v. Oklahoma Corporation Commission*, 769 P.2d 1309 (Okla. 1989), the Supreme
6 Court of Oklahoma held that:

7 The utility's burden of proving that payments to affiliates are reasonable
8 includes both a burden of production and of persuasion. The utility has
9 the initial burden of producing evidence to show *prima facie* the
10 reasonableness of its payments to affiliates-a mere showing of the
11 expenses' incurrence will not suffice. The utility must produce evidence,
for example, that it charged affiliates the same amount as it did arms-
length buyers. Unless the utility meets this affirmative duty of showing
the reasonableness of payments to affiliates, no such expenses may be
allowed.⁶⁶

12 Mr. Sorensen⁶⁷ and Mr. Bourassa⁶⁸ testified that the Company should focus on the
13 reasonableness of affiliate costs, rather than the source of the costs. They argue that, if profits
14 charged by unaffiliated entities can be considered reasonable and prudent, affiliate costs and profits
15 should receive similar consideration. Thus, the Company urges the Commission to apply the same
16 standard to affiliates as it applies to non-affiliates.

17 The Company provides limited evidence to establish the reasonableness of affiliate costs. The
18 Company asserts that AWS provides part-time employees minimizing costs for Gold Canyon Sewer.
19 The Company claims that it would be forced to hire full-time workers if AWS did not provide part-
20 time employees.⁶⁹

21 Gold Canyon Sewer argues that use of part-time employees would result in unnecessary costs
22 and lower quality of work. It believes that hourly rates would be higher because of marketing costs
23 and employee down time.⁷⁰ The Company also states that the quality of service would suffer because
24

25
26 ⁶⁵ *Id.* 17 N.Y.2d at 378. See also Exhibit S-9 at 13, ll. 14-18.

27 ⁶⁶ *Id.*, 769 P.2d at 1323 (citations omitted; emphasis added).

28 ⁶⁷ A-9 at 5, line 22 to 6, line 2.

⁶⁸ A-11 at 12, ll. 23-24 and at 12, ll. 16-18.

⁶⁹ A-9 at 3, line 16 to 4, line 11; and A-11 at 8, line 22 to 9, line 4.

⁷⁰ A-9 at 3, ll. 23-26.

1 part-time employees would be less familiar with the Company and its operations.⁷¹ Finally, the
2 Company compares costs of hiring AWS employees on a full-time rather than a part-time basis. It
3 claims this comparison shows the costs are reasonable.

4 The Company further claims that Algonquin affiliates charge market competitive rates.⁷²
5 Notwithstanding its claim, Gold Canyon Sewer states, "there are no other companies that are able to
6 provide the same range and quality of services as AWS."⁷³ Mr. Sorensen testified that Algonquin
7 affiliates provide almost all of the services required by Gold Canyon. He explained that affiliate
8 transactions are "a full soup-to-nuts type of arrangement where [the affiliates] run the entire
9 facility."⁷⁴

10 Thus, there is no market for the scope of services provided by AWS. Mr. Sorensen's
11 testimony should be no surprise. Companies that provide the full range of utility services are either
12 utility holding companies or the utilities themselves. Third-party vendors providing services to
13 utilities provide niche services that are easy for utilities to out source. For example, the Company
14 identified third-party vendors that provide billing and collection services.⁷⁵ If a company wanted to
15 provide a full range of utility services, it would form a utility holding company or acquire and operate
16 utilities.

17 Several legal issues are presented by Algonquin's business model. First, affiliate *profits*
18 should not be included in the utility's rate base or operating expenses.⁷⁶ Second, Staff has serious
19 concerns about whether the Company met its burden of production for affiliate *costs*.⁷⁷ Third, Staff
20 also disagrees with the Company's characterization of the reasonableness standard. The
21 reasonableness standard does and should consider whether affiliate profits are necessary in the
22 provision of service.⁷⁸

23
24
25 ⁷¹ A-9 at 3, ll. 17-20; and A-11 at 8, line 26 to 9, line 2.

26 ⁷² A-9 at 5, ll. 8-10; and A-11 at 9, ll. 11-12.

27 ⁷³ A-11 at 6, ll. 7-12.

28 ⁷⁴ TR 1233: 25 - 1234: 12; see also *Id.* at 1235: 25 - 1236: 18.

⁷⁵ S-9 at 2-3.

⁷⁶ See footnote 36, *infra*.

⁷⁷ See Tr. 13, l. 20 - 14, l. 3.

⁷⁸ S-19 at 6, ll. 6-20.

1 Each of the latter two issues related to affiliate *costs* is addressed next. Following that
2 discussion, Staff addresses the appropriate legal standard for evaluating affiliate *profits*. It then
3 applies that standard to evidence provided by the Company.
4

5 **1. The reasonableness standard for affiliate costs.**

6 Gold Canyon Sewer has not produced sufficient, competent and reliable evidence to meet the
7 reasonableness standard. Gold Canyon merely calculated the full-time cost of AWS employees
8 working part-time for the Company.⁷⁹ Mr. Bourassa testified that economies of scale provided by
9 AWS saved ratepayers \$22,195.92 in the test year.⁸⁰

10 The Company also provided limited evidence to determine the market value of the labor costs
11 and other costs. The Company provided unsubstantiated quotes from First National Management
12 (“FNM”) and YL Technology (“YLT”). Rather than providing documentation, the Company
13 provided contacts names and numbers.⁸¹ Mr. Sorensen stated that neither vendor provides the same
14 range of services as AWS. Mr. Bourassa further testified that “the Arizona Small Utilities
15 Association (“AUSA”), as interim managers for the McClain Systems, charged a management fee of
16 \$10.50 per customer per month.”⁸² Mr. Bourassa testified that AUSA does not provide “the same
17 range and level of service as the [Algonquin] affiliates.”⁸³

18 Gold Canyon provided three documents as evidence of market rates for operating services.
19 First, the Company provided a 1998 quote for billing and bookkeeping services from Western
20 Environmental Technologies, Inc.⁸⁴ Second, Gold Canyon provided Algonquin Power’s 2005
21 “standard hourly charge out rates.”⁸⁵ Mr. Sorensen testified that Algonquin Power sets its rates “by
22 performing a rate survey of competitors in the engineering/safety fields about every three to four
23 years.”⁸⁶ The Company did not, however, provide Algonquin Power’s most recent survey or survey
24 for the time period covering the test year.

25 ⁷⁹ A-11 at 13, ll. 11-17.

26 ⁸⁰ *Id.*; see also Bourassa Rebuttal Exhibit 3.

27 ⁸¹ S-9 at 2-3.

28 ⁸² A-11 at 12, line 24 to 13, line 9.

⁸³ *Id.* at 13, ll. 5.

⁸⁴ S-9.

⁸⁵ *Id.*

⁸⁶ A-9 at 5, ll. 8-10.

1 Third, the Company provided a project fee proposal from Carollo Engineers to LPSCO.⁸⁷
2 Apparently, Gold Canyon suggests an appropriate comparison is the hourly rates listed in the project
3 proposal to APS's standard hourly rates. The information is insufficient to compare the costs of
4 projects performed by APS for Gold Canyon. Different contractors may bid different hours for the
5 same project.

6 Gold Canyon also did not attempt to issue a request for proposals ("RFPs") for any services
7 provided by its affiliates. Mr. Bourassa testified as follows:

8 [O]btaining competitive bids is difficult, if not impossible. As I
9 testified, the Company is not aware of any local firms that provide
10 or even have the ability to provide the same range of services
11 GCSC's affiliates. But, the fact that there are no "competitive"
12 bids does not mean there is not meaningful information from
13 which the reasonableness of the costs can be tested. While the
14 comparison is not an apples-to-apple, as the known non-affiliates
15 provide a narrower range of service, the information can be used to
16 show that the overall cost of the affiliated services is reasonable.⁸⁸

17 Mr. Sorensen further testified that, "I am not aware of any [competitor's] existence in the greater
18 Phoenix market. I can also state that I have not been approached by any company asking to provide
19 [the same affiliate services] to GCSC or any other Algonquin-owned utility."⁸⁹

20 Mr. Bourassa also argued that Staff did not conduct an independent analysis of whether the
21 costs were reasonable.⁹⁰ Gold Canyon's counsel, Mr. Shapiro, admitted that the Company has the
22 initial "burden in the first instance to show the reasonableness" of costs from affiliate transactions.⁹¹
23 Mr. Shapiro also addressed issues raised in the Black Mountain Sewer compared to the Gold Canyon
24 case. He explained:

25 We did object to initial data requests by Staff that asked questions
26 about the manner in which the profit was determined. Ultimately
27 in working things out with Staff we provided them with
28 information they deemed sufficient to satisfy the data request
without involving the Hearing Division.

But I don't believe, and again I will stand corrected, that the
Company ever took the position that it would preclude Staff from

⁸⁷ S-9.

⁸⁸ A-12 at 9, ll. 7-16.

⁸⁹ A-11 at 6, ll. 9-12.

⁹⁰ A-11 at 13, ll. 18-22; see also A-12 at ll. 19-26.

⁹¹ TR 354: 25 - 355: 5.

1 doing some sort of an audit if it would lead to a determination of
2 the reasonableness of the cost.

3 And, again, I would point out that cost itself has not been the issue;
4 it's the profit above the cost that Staff has taken issue with.⁹²

5 Mr. Sorensen provided testimony confirming Mr. Shapiro's statements.⁹³

6 Impossibility should not be used as an excuse to not provide sufficient, competent and reliable
7 evidence on the reasonableness of costs.⁹⁴ As the *Turpen* court noted, "a mere showing of the
8 expenses' incurrence will not suffice. The utility *must* produce evidence."⁹⁵ The *Turpen* court also
9 held that affiliate costs must be the same as non-affiliates would receive from arms-length
10 negotiations.⁹⁶ In *Phelps Dodge Corp. v. Arizona Electric Power Co-op, Inc.*⁹⁷, the Arizona Court of
11 Appeals held that the Commission may not allow the competitive market to set rates. The
12 Commission has a "duty to set *just* and reasonable rates that provide for the needs of all whose
13 interests are involved, including public service corporations and *the consuming public*."⁹⁸

14 As discussed above, the Company admits that affiliate transactions require greater scrutiny.
15 But greater scrutiny is problematic with the Company's organizational model. Rather than simply
16 greater scrutiny for a few isolated transactions, greater scrutiny is needed for all of Gold Canyon's
17 operations. Sample auditing and limited comparables are insufficient.

18 Because of Algonquin's organizational model, Gold Canyon should have a higher initial
19 burden of production than other regulated utilities. Furthermore, Algonquin did not investigate
20 appropriate organizational models for regulated utilities prior to its entrance into the industry.⁹⁹ Mr.
21 Sorensen did not know if Algonquin investigated acceptable models for states that use (1) a historic
22 test year; or (2) "the standard rate base/rate of return kind of regulatory structure."¹⁰⁰ Company
23 witness Mr. David Kerr verified that Algonquin did not understand ROE regulation.¹⁰¹

24 ⁹² *Id.* at 355:25 – 356: 13.

25 ⁹³ *Id.* at 1219: 2-16.

26 ⁹⁴ *Cf. Turpen*, 769 P.2d at 1324, fn. 43 (The court recognized when "there may not be a readily ascertainable market
27 price," the preferred method for billing affiliates is on an incremental cost basis.).

28 ⁹⁵ *Turpen*, 769 P.2d at 1323 (citations omitted; emphasis added).

⁹⁶ *Id.*

⁹⁷ 207 Ariz. 95, 108, 83 P.3d 573, 586 (App.2004).

⁹⁸ *Id.* (emphasis added).

⁹⁹ TR 1259: 21 – 1260: 13.

¹⁰⁰ TR 327: 5 – 328: 10.

¹⁰¹ TR 1251: 4-7.

1 The issue is not whether the costs billed to Gold Canyon Sewer are market competitive. The
2 issue is not whether the Company's organizational model creates economies of scale. The issue is
3 whether the costs are just and reasonable and fair to captive ratepayers.

4 If AWRA operated like every other utility holding company in Arizona, it would create a
5 shared service center. Indeed, if AWRA would not use a shared services center, it would be
6 operating imprudently. AWRA's affiliates, AWS, Algonquin Power and APT, are operating like a
7 shared services center. But because AWRA relies almost entirely on affiliate transactions rather than
8 using a prudent regulatory model, it creates unnecessary regulatory complexity. The complexity
9 benefits unit holders, but not ratepayers.

10 Gold Canyon has not met its burden of production or burden of persuasion. Moreover, the
11 Company's evidentiary problem should not be viewed as Staff's evidentiary problem. The Company
12 attempts to shift its burden of production to Staff. Mr. Bourassa claims that Staff should be able to
13 determine reasonableness of costs based on its experience or an independent analysis.¹⁰² The initial
14 burden should remain with the Company. And Gold Canyon has not presented sufficient, competent
15 and reliable evidence to satisfy its burden.

16 Three examples of consequences resulting from Algonquin's organizational model illustrate
17 its incompatibility with ratemaking principles. First, Gold Canyon claims that AWS saved ratepayers
18 \$22,195.92. If AWRA used a shared services center, it would have saved ratepayers approximately
19 \$115,802.92 ($\$22,195.92 + \$78,607^{103} + \$15,000^{104}$). Staff witness Ms. Crystal Brown testified that
20 other Arizona utilities receive affiliate services at cost.¹⁰⁵ She explained that affiliate profits are
21 imprudent because they are not needed in the provision of service.¹⁰⁶

22 Second, Staff agrees with Judge Nodes that just and reasonable rates may require a
23 comparison with similarly situated utilities. Judge Nodes asked Mr. Sorensen if he believed that
24 approximately \$700 per month was a reasonable expense for a company with 5,000 customers.¹⁰⁷ He
25

26 ¹⁰² A-12 at 8, ll. 20-26.

27 ¹⁰³ S-20, Schedule CSB-19.

28 ¹⁰⁴ Tr. 404: 4-12 (approximate annual revenue requirement on \$67,449 of capitalized affiliate profit).

¹⁰⁵ S-19 at 7, ll. 15-23; see also S-28.

¹⁰⁶ S-19 at 10, ll. 1-8.

¹⁰⁷ Tr. 1214: 16-19.

1 responded that "based upon my experience that these charges are consistent with providing the
2 service, so, yes, I would say it's reasonable."¹⁰⁸

3 But, Mr. Sorensen admitted that there may be opportunities to reduce the costs by procuring
4 bundled services.¹⁰⁹ Furthermore, Mr. Sorensen did not testify that other utilities with approximately
5 5,000 customers require telecommunications in the amount of \$700 per month. Incredibly, AWS also
6 charges a profit margin on telephone expenses, materials and supplies, prepaid license fees and
7 permits, rental equipment and transportation expenses.¹¹⁰

8 What financial incentive do employees of AWS have for minimizing costs for Gold Canyon's
9 ratepayers? Ms. Brown testified that Algonquin's incentive is to maximize profits.¹¹¹ Under
10 Algonquin's business model, the higher the expenses, the higher the profit.

11 Third, the Company has no independent representative for procuring necessary services. As
12 discussed in the introduction, the same individuals represent AWS and Gold Canyon. AWRA and
13 Gold Canyon have no employees. The fees charged by AWS are set by AWS employees and
14 approved by management at APT. There is no arms-length negotiation. Ms. Brown testified that:

15 The shareholders of Gold Canyon have turned the day to day
16 operations and management of Gold Canyon, something most
17 stand-alone utilities routinely perform, over to an unregulated
18 affiliate. The owners then charge the customers of Gold Canyon a
profit via the affiliate for performing those services.¹¹²

19 Mr. Sorensen's response demonstrates a lack of understanding of regulated utilities. He
20 argues:

21 AWS is a business, not a charity. The purpose of a business is to
22 make a return on an investment or a profit. Mere cost recovery is
23 not the goal of the business. If the affiliates' best case scenario is
24 cost recovery (0% profit), we must evaluate whether or not it is in
25 the right business or if it is serving the right customers.¹¹³

26 ¹⁰⁸ *Id.* at ll. 20-22.

27 ¹⁰⁹ *Id.* at 1215: 3-14.

28 ¹¹⁰ S-4 at schedule for affiliate transactions with AWS.

¹¹¹ S-19 at 9, ll. 1-13.

¹¹² *Id.* at 4, ll. 19-25.

¹¹³ A-9 at 8, ll. 16-19.

1 Company witness Mr. David Kerr testified that “we were a bit naïve when we first got into the utility
2 business.”¹¹⁴ Mr. Kerr explained that Algonquin “kind of invented [its utility business model] as we
3 went along.”¹¹⁵

4 Furthermore, the conflicts of interest go beyond AWS, Algonquin Power and APT. Mr.
5 Dodds is the President of Gold Canyon Sewer, AWRA, and Division Manager of APIF’s utility
6 infrastructure division.¹¹⁶ Mr. Dodds reports to Mr. Vito Ciciretto, the Chief Operating Officer of
7 APIF.¹¹⁷

8 Mr. Kerr, Mr. Chris K. Jarratt, and Mr. Ian E. Robertson are co-Chief Executive Officers
9 (“CEOs”) of APIF.¹¹⁸ They perform these roles through a management contract with Algonquin
10 Power Management, Inc. The three co-CEOs are the only directors or employees of Algonquin
11 Power Management. Algonquin Power Management manages the business of APIF.¹¹⁹ Mr. Kerr
12 (and presumably Mr. Jarratt and Mr. Robertson) is also a director of every company owned by
13 APIF.¹²⁰

14 The Company could have done much more to gather sufficient, competent and reliable
15 evidence to meet its burden of production. Some independent standard must be used to determine the
16 reasonableness of affiliate costs. In an open, competitive market, it may be reasonable to assume that
17 contract prices reflect market prices. Nevertheless, under *Phelps Dodge* market prices may be unjust
18 and unreasonable for utility ratepayers.

19 That possibility is particularly true when the prices are rates typically charged to unregulated
20 entities. Other than AWRA subsidiaries, the Company did not identify any other regulated utilities
21 that are customers of APS. The reasonableness of affiliate costs should not rely primarily on
22 company assertions.¹²¹

23
24
25 ¹¹⁴ TR 1259: 6-20.

26 ¹¹⁵ *Id.* at 1259: 21 – 1260: 13.

27 ¹¹⁶ TR 1285: 2-23.

28 ¹¹⁷ TR 1289: 11-15.

¹¹⁸ S-6 and TR 1287: 25 – 1288: 6.

¹¹⁹ TR 1287: 18-21.

¹²⁰ *Id.* at 22-24.

¹²¹ S-19 at 8, ll. 7-10.

1 The Commission should require Gold Canyon Sewer to, at the very least, issue a RFP and
2 attempt to obtain competitive bids. An RFP also does not need to be limited to the local area as
3 suggested by the Company. For example, AWS also provides services in Texas, Missouri and
4 Illinois. APS provides services in Canada and the United States.¹²²

5 Finally, Staff does not agree with the Company's simplified version of the reasonableness
6 standard. Ms. Brown offered a nonexclusive list of considerations for determining the reasonableness
7 of affiliate costs and profits. The considerations are more appropriate for reviewing limited affiliate
8 transactions than for reviewing Algonquin's organizational model. For typical affiliate transactions,
9 the following factors should be considered:

- 10
11 (1) whether or not the cost was needed in the provision of service;
12 (2) the used and usefulness;
13 (3) the prudence of the expense; and
14 (4) whether the affiliate had to forgo other profitable opportunities in
15 order to provide service to the utility should be considered in
16 determining whether an expense should be allowed for ratemaking
17 purposes. Only in certain circumstances when the affiliate has to
18 forgo other profitable opportunities and the utility does not have a
19 better alternative for the services provided should an affiliate profit
20 be allowed in the cost of service.¹²³

21 Case law and state commission decisions have been in accord with Ms. Brown's factors. For
22 example, in *Washington Utilities & Transportation Commission v. Washington Water Power*
23 *Company*, 24 P.U.R. 4th 427 (1978), the Washington Utilities and Transportation Commission held
24 that "the only method of determining the *fairness* and reasonableness of [affiliate costs] is to
25 determine the reasonableness of the return to the [utility] on their property used and useful in the
26 business."¹²⁴ In rejecting related companies' ability to earn a "double profit,"¹²⁵ the Washington
27 Commission concluded that:

28 [A] company enjoying the immunities of a public utility has no right to
impose upon the consumers a heavier burden than that which would be
justly borne, and that will produce a proper rate of return, considering the

¹²² TR 364: 10-13.

¹²³ S-19 at 6, ll. 6-15.

¹²⁴ *Id.* at 10 (publication pages not available, page reference is to Westlaw printout) (citing *Wichita Gas Co. v. Kansas*
Pub. Service Commission, 2 F Supp 792 (DC Kan 1933) (emphasis added).

¹²⁵ *Id.*

1 value of the property devoted to this public service and to the risks
2 involved.¹²⁶

3 The factors above, however, were not Staff's primary basis for recommending disallowance
4 of affiliate profits.

5 Ms. Brown testified that:

6 [I]ts Staff's belief that Gold Canyon and all of its affiliates are one and
7 the same, that you cannot earn a profit from buying and selling from
8 yourself, and that Gold Canyon has no employees so that Gold Canyon
9 needs a service provided to it.¹²⁷

10 In other words, Staff recommends that the Commission pierce the corporate veil, and ignore the shell
11 corporate structures created for Gold Canyon Sewer and its parent, AWRA.

12 **2. The Commission should treat Gold Canyon Sewer and its Algonquin**
13 **affiliates as a single entity and exclude all affiliate profits.**

14 AWRA, AWS, Algonquin Power and APT should be considered the alter egos of Gold
15 Canyon Sewer. The facts of this case are so extreme that the Company should have anticipated that
16 the Commission would pierce the corporate veil. The standard for piercing the corporate veil makes
17 it irrelevant whether Algonquin's organizational structure results in lower costs to ratepayers.¹²⁸
18 Furthermore, use of an independent method for determining market prices cannot justify affiliate
19 profit if the Commission pierces the corporate veil for Algonquin.

20 In *Arizona Public Service Co. v. Arizona Corporation Commission*, the Arizona Court of
21 Appeals noted in dicta that the Commission may pierce the corporate veil to prohibit a utility and its
22 affiliates from evading regulation by means of the affiliate relationship.¹²⁹ Prior to the Black
23 Mountain Sewer case, the Commission had not expressly invoked the standard for piercing the
24 corporate veil and disallowing affiliate profit. But it has used the standard in two cases. In Decision
25 No. 57666, the Commission held:

26 ¹²⁶ *Id.* at 14.

27 ¹²⁷ TR 1152: 17-21.

28 ¹²⁸ S-19 at 8, ll. 12-19.

¹²⁹ 155 Ariz. 263, 746 P.2d 4 (App. 1987) (Publication pages were not available, but see page 5 in Westlaw printout.),
Arizona Public Service Co. v. Arizona Corporation Commission, 157 Ariz. 532, 760 P.2d 532 (1988) (reversed in part on
other grounds).

1 The Company portrayed outrage that the Commission would attempt to
2 regulate its non-regulated entity, CUC. In response to the Company's
3 last argument, we will simply state that the Commission only has to
4 approve reasonable expenses for ratemaking purposes, whether those
5 expenses originate from a regulated or non-regulated entity is not
6 controlling. Staff has raised the issue of reasonableness of the expenses
7 allocated from an entity related to the Company and we agree that those
8 expenses should be carefully scrutinized. *We do not believe it is
appropriate for ratepayers to pay a profit margin for each layer of
related companies. Hence, we totally agree with Staff that all of the
profit margin of CUC should be disallowed as part of the allocation.
However, it is unclear from this case as to the actual amount of such
profit.* For that reason we will approve of the CUC allocation, but shall
direct the Company in its next rate case to provide the amount of profit
to CUC under its contractual arrangement.¹³⁰

9 As early as 1925, the Supreme Court of Arizona held that "courts will disregard corporate
10 form when justice requires it to look to the substance and not to the shadow,"¹³¹ More recently, the
11 United States District Court of Arizona explained that "Under Arizona law..., [t]hose seeking to
12 pierce the corporate veil must show that 'the financial setup of the corporation is only a sham and
13 causes an injustice.'"¹³² Under the alter ego theory, a plaintiff "must prove both (1) unity of control
14 and (2) that observance of the corporate form would sanction a fraud or promote injustice."¹³³

15 Although piercing the corporate veil is often used to reach individuals who own a corporation,
16 it also applies when a corporation is the owner. As early as 1938, the Supreme Court of Arizona
17 explained the unity of control prong for two corporations. In *Walker v. Southwest Mines
18 Development Company*, 52 Ariz. 403, 81 P.2d 90 (1938), the court held:

19 [W]hen one corporation so dominates and controls another to make that
20 other a simple instrumentality or adjunct to it, the courts will look
21 beyond the legal fiction of distinct corporate existence, as the interests
22 of justice require; and where stock ownership is resorted to not for the
purpose of participating in the affairs of the corporation in the
customary and usual manner, but for the purpose of controlling the

23 ¹³⁰ *In the Matter of the Application of Consolidated Water Utilities, LTD., Apache Junction Division for an Increase in its*
24 *Water Rates and Charges for Water Service in its Certificated Area in Pinal County, Arizona, et. al.*, Docket Nos. E-
25 1009-90-115 and E-1005-90-116, Decision No. 57666 at 18, I. 17 - 19, I. 5 (December 19, 1991), *Consolidated Water*
26 *Utilities v. ACC*, 178 Ariz. 478, 875 P.2d 137 (App. 1994) (reversed in part on other grounds); see also (which is in
accord with Decision No. 57666) *In the Matter of the Application of Consolidated Water Utilities, LTD., Apache Junction*
Division for an Increase in its Water Rates and Charges for Water Service in its Certificated Area in Pinal County,
Arizona, et. al., Docket Nos. E-1009-92-135 and E-1009-92-252, Decision No. 58260 at 19, II. 24-25 (April 09, 1993).

27 ¹³¹ *Gonzalez & Co. Brokers, Inc. v. Thomas*, 42 Ariz. 308, 312, 25 P.2d 552, 554 (1933), quoting *Phoenix Safety*
Investment Co. v. James, 28 Ariz. 514, 237 P. 958, 959 (1925).

28 ¹³² *Keams v. Tempe Technical Institute, Inc.*, 993 F.Supp. 714, 724 (D.Ariz. 1997), quoting *Ize Nantan Bagowa, Ltd. v.*
Scalia, 118 Ariz. 439, 577 P.2d 725, 729 (App. 1978).

¹³³ *Gatecliff v. Great Republic Life Insurance Co.*, 170 Ariz. 34, 37, 821 P.2d 725, 728 (1991).

1 subsidiary company so that it may be used as a mere agency or
2 instrumentality of the owning company, the court will not permit itself
3 to be blinded by mere corporate form, but will, in a proper case,
disregard the corporate entity, and treat the two entities as one.¹³⁴

4 In *Deutsche Credit Corporation v. Case Power & Equipment*, the Arizona Court of Appeals held:

5 Two corporations can be regarded as the same if 'the dominant
6 corporation...so control[s] and use[s] the other as a mere tool or
instrument in carrying out its own plans and purposes that justice requires
it to be held liable for the results...' ¹³⁵

7 The second prong has been discussed in a number of utility cases. In *State of North Carolina*
8 *v. Morgan*, 177 S.E.2d 405 (N.C. 1970), the Supreme Court of North Carolina held that "the doctrine
9 of the corporate entity may not be used as a means for defeating the public interest and circumventing
10 public policy." The Supreme Court of Louisiana was more specific and held, "Manipulation by a
11 parent utility of a subsidiary for the purpose of creating excessive profits at the expense of the rate
12 payer would provide a reason for the regulatory agency to disregard [the] corporate entity..."¹³⁶

13 Finally, state commission in Washington expressed the injustice as follows:

14 [T]he clearly stated concern appears to be not the level of price at which
15 the transaction is accomplished in comparison with prices in nonaffiliated
16 transactions, but instead a level of earnings by the unregulated arm of the
17 utility at a rate higher than the utility is authorized and would be allowed
to achieve if no corporate device were utilized. In effect, the courts
approve for rate-making purposes the placement of a 100 percent affiliate
in the same position as an integrated [part] of a utility.¹³⁷

18 In the recent Black Mountain Sewer case, the Commission directly addressed the standard for
19 piercing the corporate veil. The Commission held:

20 The question that must be asked is whether an affiliate company
21 under common ownership and control should be permitted to add
22 an additional layer of profit, and to do what a regulated public
service corporation is otherwise legally prohibited from doing (*i.e.*
23 recover an additional profit margin for its services), based solely
on the parent company's decision to create a separate affiliate
company. Our answer is a resounding no.¹³⁸

24 The facts of this case are not substantially different than the facts of the Black Mountain Sewer case.

26 ¹³⁴ *Id.*, 52 Ariz. at 414-415, 81 P.2d at 95, quoting *Platt v. Bradner Co.*, 131 Wash. 573, 230 P. 633 (Wash. 1924).

27 ¹³⁵ 179 Ariz. 155, 876 P.2d 1190 (App. 1994), quoting *Jabczenksi v. Southern Pacific Memorial Hospital, Inc.*, 119 Ariz.
15, 21, 579 P.2d 53, 59 (App. 1978).

28 ¹³⁶ *Central Louisiana Electric Co. v. Louisiana Pub. Serv. Comm.*, 373 So.2d 123, 126 (La. 1979) (citations omitted).

¹³⁷ *Washington Water Power Co.*, 24 P.U.R. 4th at p. 11.

¹³⁸ Decision No. 69164, ll. 1-5.

1 Staff believes that the record in this case easily satisfies both prongs of the standard for
2 piercing the corporate veil. For the unity of control prong, the most significant fact is that Gold
3 Canyon Sewer and AWRA have zero employees. The only employees that provide utility service
4 work for AWS, Algonquin Power and APT. The same directors and officers control the affiliates and
5 Gold Canyon. Algonquin affiliates provide virtually all of the services necessary for utility service.
6

7 The individual Algonquin officers and directors have multiple, conflicting roles within the
8 Algonquin family of companies. Before describing those roles, the individuals who executed the
9 AWS contract and implement it must be identified. On January 1, 2004, Mr. Kampian executed the
10 contract as the President of Gold Canyon. Mr. Dodds executed the contract on behalf of AWS. Mr.
11 Dodds helps prepare the annual budget on behalf of AWS. Mr. Kampian reviews and approves the
12 budget in his role at APT.

13 Mr. Dodds is currently the President of Gold Canyon and manages APIF's utility
14 infrastructure. AWS is part of the utility infrastructure. Mr. Kampian is currently the President of
15 AWS and the Chief Financial Officer of APIF (and apparently has a role at APT, but there is no
16 evidence about his role). Mr. Dodds reports directly to Mr. Ciciretto. Mr. Kampian and Mr. Ciciretto
17 report to Mr. Kerr and the other co-CEOs. Mr. Kerr testified that he (and presumably the other co-
18 CEOs) is a director of all of the companies.

19 In *Gatecliff, supra*, the Arizona Supreme Court relied on a record that suggested an affiliate
20 "exercised 'substantially total control over the management and activities of [its sister
21 corporation].'"¹³⁹ For example, the contract "established that [the affiliate] performed virtually every
22 service necessary for [its sister corporation's] operation."¹⁴⁰ The court also noted that the contract
23 was not negotiated at arms length.¹⁴¹

24 The record easily supports the conclusion that Gold Canyon Sewer is a mere agency or
25 instrumentality of the Algonquin affiliates. Gold Canyon Sewer can only operate through Algonquin
26

27 ¹³⁹ *Gatecliff*, 170 Ariz. at 37, 821 P.2d at 728 (quotation omitted).

28 ¹⁴⁰ *Id.*

¹⁴¹ *Id.*

1 affiliates. The record also easily supports the conclusion that observing the corporate legal fictions
2 would result in an injustice to ratepayers.

3 The injustice in this case is that Algonquin seeks profits that are not permitted under ROE
4 regulation. Algonquin seeks profits for (1) operating expenses; (2) ROE on its rate base, and a return
5 for its affiliates on capitalized affiliate costs (i.e. two returns on the same rate base); and (3) a ROE on
6 capitalized affiliate profits. Algonquin's corporate structure creates a very slippery slope for the
7 Commission's Constitutional mandate to set just and reasonable rates. The mandate has always
8 included setting an allowable ROE only for invested plant.

9 The Company would like the Commission to simply focus on savings to ratepayers.¹⁴² The
10 state commission of Washington rejected this argument because the consolidated companies would
11 earn a higher return than the utility's allowed ROE. So has this Commission.

12 Algonquin's suggestion that its affiliates may stop providing service if they only receive cost
13 recovery is no reason to treat ratepayers unjustly. Ratepayers should not have to choose between
14 paying a premium over a utility's allowed ROE, or receiving less efficient, more costly service. The
15 Commission should require AWRA to continue to operate a shared services center.

16
17 **B. The Commission Should Disallow \$34,807 of Allocated APT Overhead.**

18 Gold Canyon requested \$48,000 (\$4,000 per month) in overhead expenses allocated by APT.
19 To support the expenses, Gold Canyon provided a schedule of allocations among AWRA's regulated
20 utilities.¹⁴³ Staff recommends a disallowance of \$34,807.¹⁴⁴ Ms. Brown testified that "Staff allowed
21 allocated overhead costs related to the corporate consolidated audit, corporate tax expenses, corporate
22 computer hardware and software, and corporate networks, servers, and email."¹⁴⁵ Staff also allowed
23 two months of the allocation for professional services.¹⁴⁶

24 Mr. Bourrassa testified that:
25

26

¹⁴² *Id.* 515, l. 25 - 516, l. 10.

27 ¹⁴³ S-4 at CSB 2.38d.

28 ¹⁴⁴ S-18 at 26, ll. 7-9.

¹⁴⁵ S-19 at 18, ll. 6-9.

¹⁴⁶ TR 1141: 3-5.

1 All of the costs allocated to the Company for central office costs
2 are typical of overheads allocated to subsidiaries. Staff excludes
3 allocated salaries and wages, office rent, legal and travel. All of
these are legitimate costs for services the Company incurs to serve
customers.¹⁴⁷

4 He also claimed that Staff's disallowance was primarily based on its assertion that "executive
5 salaries, corporate office rent, corporate travel and corporate legal are not needed for the provision of
6 service to rate payers."¹⁴⁸

7 Staff did make the above argument. But the argument was based on a lack of supporting
8 documentation. Ms. Brown conceded that the costs may be incurred on behalf of ratepayers.¹⁴⁹ Ms.
9 Brown testified that the Company did not provide "any studies, time sheets, and/or unaffiliated third
10 party invoices" to support the costs.¹⁵⁰ At the hearing, Ms. Brown testified extensively about the
11 supporting documentation needed to support the costs.¹⁵¹

12 Staff's audit process is necessary and appropriate for verifying operating expenses and rate
13 base costs. In its direct testimony, Staff originally disallowed \$7,603,327 for new plant.¹⁵² Staff's
14 recommended disallowance was based on a lack of supporting documentation.¹⁵³ When the
15 Company provided the documentation, Staff removed its disallowance.¹⁵⁴

16 Staff's audit process and requirements for reviewing supporting documentation is required by
17 Arizona Administrative Code ("AAC") § R14-2-610 D.1¹⁵⁵ Additionally, in the Black Mountain
18 Sewer case, the Commission held that "in future cases involving the Algonquin companies, we expect
19 all affiliate salaries, expenses and billings to be scrutinized to avoid potential abuses."¹⁵⁶ Because
20 supporting documentation was not provided, the Commission should disallow \$34,807 in allocated
21 overhead from APT.

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23
24 ¹⁴⁷ A-11 at 14, ll. 1-5.

¹⁴⁸ A-12 at 13, ll. 3-5, citing S-19 at 18.

25 ¹⁴⁹ S-19 at 18, ll. 18-22.

¹⁵⁰ *Id.* at 19, ll. 1-4.

26 ¹⁵¹ TR 1137: 10 -

¹⁵² S-18 at 7, ll. 12-16.

27 ¹⁵³ *Id.* at 8, ll. 7-12.

¹⁵⁴ S-19 at 3, ll. 5-8.

28 ¹⁵⁵ S-18 at 7, ll. 18-24.

¹⁵⁶ Decision No. 69164 at 19, ll. 3-5.

1
2 **III. RATE BASE**

3 Many of the disagreements between Staff and the Company related to rate base have been
4 resolved during the case. The Company proposes that its adjusted test-year rate base, i.e. its original
5 cost rate base ("OCRB"), be used as its fair value rate base ("FVRB").¹⁵⁷ In its Rejoinder Testimony,
6 the Company requested plant in service in the amount of \$21,033,564, and an adjusted rate base of
7 \$15,742,719.¹⁵⁸ Staff's final recommendation for plant in service is \$21,033,564, and for adjusted
8 rate base is \$15,725,787.¹⁵⁹

9 The Company still disputes Staff's disallowance of \$67,449 of capitalized affiliate profit.
10 Staff and the Company also dispute whether certain plant should be expensed or capitalized. Staff
11 already addressed capitalized affiliate profit above. Therefore, it will not do so again in this section.
12 Staff also addresses issues raised by parties on odor issues and on whether plant additions for Gold
13 Canyon's wastewater treatment facility resulted in excess capacity.

14
15 **A. The Commission Should Increase Rate Base by \$13,809 for Plant which was
16 Expensed When it Should Have Been Capitalized.**

17 Staff recommends increasing rate base by \$13,809 and decreasing operating expenses by a
18 corresponding amount.¹⁶⁰ Staff's recommendation is based on AAC § R14-2-610 D.1 and the
19 Uniform System of Accounts ("USOA") of the National Association of Regulatory Utility
20 Commissioners ("NARUC").¹⁶¹ The disallowed amount is based on three invoices: (1) \$3,166, (2)
21 \$8,995, and (3) \$1,648. The first two amounts were incurred for engineering inspections by CSA
22 Engineering, an independent contractor.¹⁶² The third amount was incurred for laboratory
23 equipment.¹⁶³

24
25
26 ¹⁵⁷ A-10 at 5, ll 11-13.

27 ¹⁵⁸ A-12 at Rejoinder Schedule B-1, lines 1 and 27.

28 ¹⁵⁹ S-20 at Schedule CSB-3, line 1 and 15.

¹⁶⁰ S-18 at 13, ll. 20-22 and at 19, ll. 21-23.

¹⁶¹ S-18 at 12, line 16 to 13, line 18.

¹⁶² S-19 at 10, ll. 10-15.

¹⁶³ Schedule CSB=14, line 4.

1 Gold Canyon claims that 40% of the first two amounts should be expensed. Mr. Bourassa
2 testified that expenses (1) for routine office duties and research¹⁶⁴, (2) and for blue staking and sewer
3 tap service should be expensed¹⁶⁵. Mr. Bourassa provided invoices and time sheets in his Rejoinder
4 Testimony (RUCO 3.4) to support his position.

5 Some of Mr. Bourassa's testimony is contradictory. In his Rebuttal Testimony, he stated,
6 "Concerning the two engineering invoices, some of the work performed during the engineering
7 inspections included *blue staking* and certifications which the Company agrees should be
8 capitalized."¹⁶⁶ In his Rejoinder Testimony, he states that "some of the blue staking and sewer tap
9 service were not for Company capital projects, but were for builders."¹⁶⁷ He then states for, "Any
10 time hours....present under the categories 'Utility Marking, Plan Review', or 'Construction
11 Inspection', the work perform[ed] is for Company owned capital projects."¹⁶⁸

12 Ms. Brown reviewed the invoices and time sheets. Ms. Brown found that the office duty
13 activities all related to "directly supported capitalizable activities."¹⁶⁹ She also found that all of the
14 blue staking was listed under either Utility Marking or Construction Inspection.¹⁷⁰ In S-23, Ms.
15 Brown included a table to support her findings. Staff requests the Commission to find that all of the
16 costs should be capitalized.

17
18 **B. Odor Issues.**

19 The Commission has the authority and the duty to protect the health, safety and welfare of
20 a public service corporation's customers. The Commission has the ability to investigate the
21 numerous complaints concerning odor and if necessary recommend appropriate measures to
22 remediate odor problems. ARS §40-321 states:

23
24 When the commission finds that the equipment, appliances, facilities or
25 service of any public service corporation, or the methods of

26 ¹⁶⁴ A-11 at 7, ll. 8-10; see also A-12 at 6, ll. 10-12.

¹⁶⁵ A-12 at 6, ll. 13-25.

¹⁶⁶ A-11 at 7, ll. 6-8.

¹⁶⁷ A-12 at 6, ll. 15-16.

¹⁶⁸ *Id.* at 7, ll. 8-10.

¹⁶⁹ S-23 at 1.

¹⁷⁰ *Id.*

1 manufacture, distribution, transmission, storage or supply employed by
2 it are unjust, unreasonable, unsafe, improper, inadequate or insufficient,
3 the commission shall determine what is just, reasonable, safe, proper,
4 adequate or sufficient and shall enforce its determination by order or
5 regulation.

6 The Commission has further authority under ARS § 40-361(A), to direct additions,
7 improvements or changes to existing plant or physical property to promote the security or
8 convenience of its employees or the public. Public service corporations are required by the
9 language of ARS § 40-361(B) to “furnish and maintain such service equipment and facilities as
10 will promote the safety, health, comfort and convenience of its patrons....and as will be in all
11 respects adequate, efficient and reasonable.” Gold Canyon has adequately responded to the odor
12 complaints of the public and has instituted the proper measures.

13 In response to numerous complaints, Staff made five visits to the Gold Canyon facility.¹⁷¹
14 Additionally in an August 9, 2006 letter to the docket, Commissioner Mayes requested that
15 Commission Staff investigate the numerous odor complaints and provide a report.

16 In connection with the engineering evaluation conducted in this case, Marlin Scott visited the
17 Gold Canyon facility on March 20, 2006. He was accompanied by the Company’s plant manager,
18 Charlie Hernandez. While his initial visit was not to investigate an odor complaint, Mr. Scott noted
19 no offensive odors during that visit.¹⁷²

20 Mr. Scott visited the facility again on May 25, 2006. He testified that he could not discern an
21 odor during the visit. On Mr. Scott’s third visit, which was an odor detection tour on August 8, 2006,
22 he detected an odor.¹⁷³ The Company explained that there were three pumps damaged during a storm
23 on July 21, 2006. In the repair of the pumps, the Company opened the vault cover that housed the
24 sludge pumps.¹⁷⁴ Mr. Scott testified that the odor was detected in the immediate area of the repairs
25 only. Mr. Scott last visit was August 29, 2006 for the Company’s Open House event. Mr. Scott
26 testified that he did not discern an odor during that visit.¹⁷⁵

27 ¹⁷¹ Ex. S-2 at 2.

28 ¹⁷² *Id.*

¹⁷³ *Id.* at 2-3.

¹⁷⁴ *Id.*

¹⁷⁵ Tr. 1035-36

1 The Company produced three witnesses to testify regarding the numerous customer odor
2 complaints at its facility. William Hare, a field inspector and compliance officer with the Arizona
3 Department of Environmental Quality (ADEQ), testified regarding his inspections of the facility. Mr.
4 Hare testified that he has visited Gold Canyon approximately sixteen times in the last 5 years.¹⁷⁶ On
5 May 10, 2006, he conducted an annual compliance audit as part of his normal inspection process and
6 as a result of customer complaints. During that inspection, he noted a "musty" odor but not the
7 offensive odor that can be caused by hydrogen sulfide.¹⁷⁷

8 The results of Mr. Hare's June 13, 2006 report found that the Company was compliant with
9 ADEQ regulations concerning odor, but was in violation of the ADEQ rules regarding its Aquifer
10 Protection Permit. Additionally, Mr. Hare found that the Company had furnished water to three golf
11 courses without a valid Reclaimed Water General Permit.¹⁷⁸ ADEQ issued two Notices of
12 Violations, which were subsequently addressed by the Company and remedied.¹⁷⁹ Mr. Hare also
13 testified that the odor control system for Gold Canyon was among the more sophisticated systems
14 that he had seen.¹⁸⁰

15 Mr. Hare also conducted an odor assessment visit in October 2006. His report indicated that
16 there were no significant sources of odors. But there were some areas of faint and intermittent odors
17 emanating from the Bashas Shopping Center as well as from the facility.¹⁸¹ During the visit, there
18 was routine maintenance being conducted on the scrubber and there were moderate septic odors in
19 and around the headworks building.¹⁸² The maintenance is performed quarterly. Once the scrubber
20 was returned to operation, the septic odors were no longer detectable.¹⁸³

21 Stephen Davidson, an engineer with the environmental engineering consulting firm, Brown
22 and Caldwell, was hired by the Company in response to a directive by the Commissioners made
23 during the Open Meeting held September 19, 2006, in Docket No. SW-02519A-06-0078. Mr.
24

25 ¹⁷⁶ Tr. 130.

26 ¹⁷⁷ Ex. A-1; Ex. Comm-1.

27 ¹⁷⁸ Ex. A-1 at 7-8.

28 ¹⁷⁹ Ex. A-7.

¹⁸⁰ Tr. 124.

¹⁸¹ Tr. 75-78.

¹⁸² Ex. A-2.

¹⁸³ *Id.*

1 Davidson testified that Brown and Caldwell was retained by Gold Canyon to conduct an odor
2 evaluation. An odor survey was conducted over 4 days during the week of October 16, 2006. Mr.
3 Davidson testified that odor detecting devices were placed around the perimeter of the facility. The
4 results of the perimeter tests ranged from 0 to 6 parts per billion. On two occasions, the detection
5 devices noted a faint short lived odor directly down wind of the odor control scrubber stack.¹⁸⁴ This
6 odor was due to a malfunctioning chemical feed system in the odor control scrubber stack.¹⁸⁵
7 According to Mr. Davidson's report, once the chemical feed system was corrected, the scrubber
8 efficiency was greater than 99 percent of H₂S removal.¹⁸⁶

9
10 Mr. Davidson testified that there were no serious odor problems with the Gold Canyon
11 facility. He further concluded that the plant from "an odor perspective is designed quite well."¹⁸⁷ He
12 also recommended that the Company purchase odor detection units like those used in the study. In a
13 filing on January 12, 2007, the Company stated that it has purchased and installed monitors at the
14 north wall, the north corner; the gate, the west wall; the east wall; the scrubber; the scrubber inlet and
15 the scrubber outlet. The Company reported in the monitoring period of December 18, 2006 to
16 January 5, 2007, that the readings at the perimeter ranged from 0 to 0.5 PPM and that readings at the
17 interior ranged from 0 to 20 PPM. (Notice of filing, January 12, 2007)

18 Finally testifying in part concerning the odor issue and the odor and noise abatement
19 equipment installation was regional operations manager Charlie Hernandez. He manages several
20 plants for Algonquin Water Services including the facility at Gold Canyon. Mr. Hernandez testified
21 that when he first started working at the treatment facility in 2003, there was a noise and odor
22 problem. He further explained that once the new odor abatement equipment was installed, the
23 complaints made to him dropped almost to zero.¹⁸⁸

24 While the abatement equipment helped with some of the odor problems, Mr. Hernandez
25 recounted that there were still problems at the Bashas' Shopping Center, a facility that is not owned

26 ¹⁸⁴ Ex. A-4 at ES-1.

27 ¹⁸⁵ *Id.*

28 ¹⁸⁶ Ex. A-4.

¹⁸⁷ Tr. 158.

¹⁸⁸ TR at 291.

1 by the Company.¹⁸⁹ Mr. Hernandez, along with Bill Hare, the owner of the Bashas' and a
2 representative from the County inspected the Bashas' and found open sewer cleanouts. The cleanouts
3 were capped.¹⁹⁰
4

5 **C. The Commission Should Find that Plant Additions for Gold Canyon's Wastewater**
6 **Treatment Facility did not Result in Excess Capacity.**

7 Staff's engineering analysis supports the Company's decision to expand its treatment facility
8 to full capacity.¹⁹¹ Mr. Scott's pre-filed testimony did not directly address the issue of excess
9 capacity. As such, Staff agreed with the Company's position to expand its plant.

10 RUCO takes the position that while it may have been a prudent business decision to expand
11 the facility to full capacity,¹⁹² the capacity beyond 1.6 million gallons per day ("gpd") should be
12 recovered when "the plant becomes truly used and useful".¹⁹³ As a result, RUCO suggest the \$2.8
13 million be excluded from rate base. It is Staff's position that no adjustments should be made because
14 of the capacity.

15 Mr. Scott's Engineering Report shows that the company had a peak test-year flow of 1.17
16 million gpd in February 2005 and that the facility will reach 80% capacity by mid 2007.¹⁹⁴ He
17 further testified that that when a company reaches 80 percent capacity, it is required to submit plans
18 to ADEQ for constructing additional capacity.¹⁹⁵ Ms. Brown testified that in her rate analysis, Staff
19 relies upon Engineering to assist in the determination of used and useful.¹⁹⁶ Staff determined that the
20 plant was used and useful and made no adjustments based on plant capacity.
21
22
23
24

25 ¹⁸⁹ Tr. 80.

26 ¹⁹⁰ Tr. 291.

27 ¹⁹¹ See S-1, Ex MSJ at 4.

28 ¹⁹² Tr. 303.

¹⁹³ Tr. 942-94.

¹⁹⁴ Ex. S-1, MSJ at 4).

¹⁹⁵ Tr. 1041.

¹⁹⁶ Tr. 1173.

1 **IV. REVENUE REQUIREMENT**

2 Staff's final recommendation for annual revenue requirement is \$4,318,481 based on an
3 adjusted rate base of \$15,725,787 and a rate of return ("ROR") of 9.2%.¹⁹⁷ Staff proposes operating
4 expenses in the amount of \$2,871,709.¹⁹⁸ Staff calculates the Company's current ROR at 2.09%.
5 Staff's proposed revenue requirement and operating expenses would result in a 72.99% increase in
6 revenue over adjusted test year revenues of \$2,496,380.¹⁹⁹

7 Staff's revenue requirement differs from the Company's revenue requirement primarily
8 because of (1) removal of affiliate profits from operating expenses; (2) removal of expenses that
9 should have been capitalized; and (3) recommended ROR. The first two issues are briefed above.
10 The third issue is briefed below.

11
12 **V. COMPANY REPRESENTATIONS MADE TO RATEPAYERS IN THE 2001**
13 **SETTLEMENT AGREEMENT AND IN SUBSEQUENT PUBLIC FORUMS**

14 In an August 9, 2006 letter to the docket, Commissioner Kris Mayes requested that two issues
15 be addressed by the parties at hearing. The first issue is whether the Company promised its
16 ratepayers that it would not raise rates for improvements related to odor control. The second issue is
17 whether investor ownership improved operations, especially related to odor control, as contemplated
18 by the 2001 Settlement Agreement.

19 Judge Nodes requested the parties to pre-file testimony and then provide testimony at hearing.
20 Mr. Steven M. Olea filed testimony on behalf of Staff on November 22, 2006. He also testified at the
21 December 4, 2007 hearing. In preparation of his testimony, Mr. Olea reviewed Commissioner
22 Mayes' letter, a fact sheet admitted by RUCO (RUCO Exhibit No. 3), and Mr. Trevor Hill's pre-filed
23 testimony.

24 Mr. Olea is most concerned with the following question and answer in the fact sheet:

25 Q: Will the upgrade mean an increase in Rates?

26
27

¹⁹⁷ Staff Brief Schedule CSB-1.

28 ¹⁹⁸ Staff Brief Schedule CSB-12.

¹⁹⁹ Staff Brief Schedule CSB-1.

1 A: No. GCSC is committed to providing the upgrade through
2 a combination of paid-in-capital and new development
hook-up fees.²⁰⁰

3 Mr. Olea testified that most customers would not understand the utility concept of paid-in-capital.²⁰¹
4 He also testified that "most customers (even those who did understand the concept) would not go
5 beyond [the] answer [no]."²⁰²

6 Mr. Olea also believes that a remedy should be imposed because "the Company's statements
7 were inaccurate and misleading."²⁰³ Mr. Olea testified that the Company's statements ignored the
8 Commission's authority to require a rate case and to approve any rate increases.²⁰⁴ Mr. Olea
9 proposed the following remedy for Judge Nodes' and the Commission's consideration:

10the Commission could order, in the decision resulting from this
11 case, the Company to make no statements in the future regarding
12 rate increases without first getting those statements approved by
the Commission. The Commission could also order the Company
13 to make no misleading or inaccurate statements to its customers
regarding any aspects of its operation. In the order the
14 Commission could also warn Gold Canyon that if the Company
ever violates this portion of the order, that the Commission will
impose monetary and/or other sanctions against the Company
15 which shall not be recovered from rate payers.²⁰⁵

16 VI. COST OF CAPITAL

17 Staff recommends a capital structure of 100% equity and 0% debt.²⁰⁶ The Company and Staff
18 agree on capital structure. Staff's final recommended ROR is 9.2%. The Company's recommended
19 ROR is 10.5%.²⁰⁷

20 Staff's recommendations use market-based financial models that have been accepted by this
21 Commission for many years. Staff uses both historical and forecasted inputs. All of Staff's inputs
22 are factors which investors can reasonably be expected to consider in determining their expected rate
23 of return. The models are also widely accepted in the financial industry and by most state
24 commissions in setting just and reasonable rates of return.

25 ²⁰⁰ RUCO-3.

26 ²⁰¹ Ex. S-16 at 4, ll. 17-24.

²⁰² *Id.*

27 ²⁰³ *Id.* at 5, line 24.

²⁰⁴ *Id.* at 5, line 23 to 6, line 24.

²⁰⁵ *Id.* at 7, ll. 2-9.

28 ²⁰⁶ Ex. S-15, SPI-1.

²⁰⁷ Ex. A-10 at 13.

1 The Company's recommendations are based on two different constant growth DCF models
2 and one multi-stage DCF model.²⁰⁸ The Company then selects its recommended ROE within the
3 range of results by comparing them to two different "approaches."

4 These "approaches" rely heavily on non-market based data and forecasts. The approaches are
5 the "risk premium approach" and the "comparable earnings approach." The Company requests an
6 increase in ROE to compensate for the Company's small firm size and individual business risk. The
7 Commission has repeatedly rejected these approaches, and risk premiums for small firm size and
8 individual business risk.

9
10 **A. The Commission Should Adopt Staff's Recommended ROE Of 10.2% Because It
Is Based On Proven Financial Models And On Balanced And Reasonable Inputs.**

11 To determine the required rate of return, Staff used the following financial models: (1) the
12 constant growth discounted cash flow ("DCF") model (8.5%); (2) the multi-stage DCF model (9.7%);
13 and (3) the capital asset pricing model ("CAPM"). Staff used two CAPM estimates, one using an
14 historical market risk premium (10.8%), and one using a current market risk premium (11.5%). Staff
15 first calculated an average for the DCF results (9.1%); then calculated an average for the CAPM
16 results (11.2%); and finally calculated the average for both models (10.2%); then Staff made a
17 financial risk adjustment of 100 basis points to reflect that Gold Canyon has less financial risk than
18 the sample companies; this financial risk adjustment results in a ROR of (9.2%).²⁰⁹ Staff's
19 recommended ROE is the average for both models.

20 For the constant growth DCF, Staff calculated the growth factor by averaging the results of
21 six different methods for calculating it.²¹⁰ The growth factor is the most frequently disputed input in
22 the model. Staff chose a balanced methodology that "gives equal weight to historical and projected
23 earnings per share ("EPS"), dividends per share ("DPS"), and sustainable growth."²¹¹ Staff witness
24 Mr. Steve Irvine testified that his choice of inputs avoids the skewing that can occur by a less
25 balanced analysis such as that prepared by the Company's witness.²¹²

26
²⁰⁸ Ex. A-10 at 41.

27 ²⁰⁹ Ex. S-15 at 3, Sch. SPI-1; S-17 at 33.

28 ²¹⁰ Ex. S-17 at 15, Sch. SPI-7.

²¹¹ Ex. S-15 at 5.

²¹² *Id.*

1 Mr. Bourassa criticized Staff's choice of inputs because the individual DCF results using
2 these growth rates produce indicated equity costs below the cost of debt.²¹³ Apparently, Mr.
3 Bourassa expects Staff to calculate six different costs of equity using each method for calculating
4 growth.²¹⁴ Then, if any result is below the cost of debt, Mr. Bourassa expects Staff to not use that
5 particular input.²¹⁵ Mr. Irvine testified that if the Commission adopted Mr. Bourassa's approach, it
6 should also exclude "the highest growth components to maintain a balanced outcome."²¹⁶ More
7 importantly, Mr. Irvine testified that it is unreasonable to assume investors ignore low outcomes and
8 accept high outcomes.²¹⁷

9 Mr. Bourassa also criticizes Staff's growth factor in its multi-stage DCF model. Although
10 Mr. Bourassa uses the same long term growth rate (6.8%), he criticized Staff's short term growth rate
11 because it was lower than its constant growth DCF growth factor.²¹⁸ Staff calculated its short term
12 growth rate using projections of dividends for each of its sample companies.²¹⁹ Mr. Bourassa's
13 criticism is obviously result driven. Mr. Bourassa explains that while financial models are useful,
14 they cannot be used [mechanically or] blindly.²²⁰

15 However, it is Mr. Bourassa, and not Mr. Irvine, that uses professional judgment
16 inappropriately. Mr. Bourassa uses a shot gun approach. He analyzes inputs by looking at the results
17 they produce when used in financial models. He then selectively rejects and accepts inputs based on
18 his initial iteration.

19 Staff chooses its inputs by first identifying available market data. It then analyzes whether
20 investors can be expected to rely on the available data. Staff inputs are pre-selected as specified from
21 a balanced methodology. Staff does not use results to determine inputs. If inputs are selected
22 appropriately, the results speak for themselves.
23

24
25 ²¹³ Ex. A-12 at 29-30.

26 ²¹⁴ *Id.* at 47.

27 ²¹⁵ *Id.* at 29.

28 ²¹⁶ Ex. S-15 at 5.

²¹⁷ *Id.*

²¹⁸ Ex. A-10, Sch. D-4.11; Ex. S-17 at 4, Sch. SPI-8.

²¹⁹ Ex. S-17 at 24.

²²⁰ Ex. A-12 at 23-24.

1 Finally, Mr. Bourassa criticizes Staff's CAPM results because (1) its risk-free rate uses spot
2 prices for five-, seven- and ten-year intermediate U.S. Treasury securities;²²¹ (2) its results don't
3 increase in lock step with increases in interest rates;²²² and (3) its current market risk premium
4 ("MRP") is unstable.²²³ The Commission has repeatedly affirmed Staff's choice of inputs for both its
5 DCF and CAPM models.²²⁴

6 Next, Mr. Bourassa claims that rising interest rates do not affect Staff's cost of capital
7 analysis.²²⁵ Mr. Bourassa ignores the fact that the CAPM model has three inputs which do not
8 necessarily move in the same direction at the same time. Mr. Irvine specifically testified that there is
9 a relationship between interest rates and the cost of equity capital.²²⁶

10
11 **B. The Commission Should Reject The Company's Recommended ROE Of 10.5%
12 Because It Is Based On "Approaches" And Choices Of Inputs That Artificially
Inflate Required Return.**

13 Mr. Bourassa testified that his recommended ROE "is based on cost of equity estimates using
14 constant growth and multi-stage growth discounted cash flow ("DCF") and *is confirmed by a risk
15 premium analysis, [a comparable earnings analysis], and my review of the economic conditions
16 expected to prevail during the period in which new rates will be in effect.*"²²⁷ Mr. Bourassa testifies
17 that his DCF results must be confirmed to comply with the *Bluefield Water Works*²²⁸ and *Hope
18 Natural Gas*²²⁹ decisions.²³⁰ The Company also argues that Gold Canyon Sewer's small size and
19 individual business risk should increase its ROE.²³¹

20
21 ²²¹ Id. at 56.

22 ²²² Id. at 57.

23 ²²³ Id. at 58.

24 ²²⁴ See e.g. *In the Matter of the Application of Southwest Gas*, Docket No. G-01551A-04-0876, Decision No. 68487 (Feb.
25 23, 2006); *In the Matter of the Application of Chaparral City Water Company*, Docket W-02113A-04-0616, Decision No.
68176 (Sep. 30, 2005); *In the Matter of the Application of Arizona Water Company*, Docket No. W-01445A-02-0619,
Decision No. 66849 (Mar. 19, 2004); *In the Matter of the Application of Rio Rico Utilities, Inc.*, Docket No. WS-02676A-
03-0434, Decision No. 67279 (Oct. 5, 2004); *In the Matter of the Application of Bella Vista Water Co., Inc.*, Docket No.
W-02465A-01-0776, Decision No. 65350 (Nov. 1, 2002).

26 ²²⁵ Ex. A-12 at 34.

27 ²²⁶ Ex. S-17 at 9.

28 ²²⁷ Ex. A-10 at 13.

²²⁸ *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923).

²²⁹ *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591 (1944).

²³⁰ Ex. A-10 at 23-24 (emphasis added).

²³¹ Id. at 27-28.

1 Mr. Bourassa uses his risk premium approach, comparable earnings approach, and the
2 Company's small size to select his final recommended ROE. His DCF results ranged from 9.2% to
3 11.6%.²³² The Commission has consistently rejected all three approaches because they inflate
4 ROE.²³³ In rejecting the risk premium and comparable earnings approaches, the Commission
5 recently held that Staff's methodology of determining ROE does not violate the *Bluefield Water*
6 *Works* or the *Hope Natural Gas* decisions.²³⁴

7 **VII. CONCLUSION**

8 For all these reasons and those presented at the hearing, Staff requests the Commission adopt
9 its positions.

10 RESPECTFULLY submitted this 23rd day of January, 2007.

11
12 

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19 Original and thirteen (13) copies
20 of the foregoing were filed this
21 23rd day of January, 2007 with:

22 Docket Control
23 Arizona Corporation Commission
24 1200 West Washington Street
25 Phoenix, Arizona 85007
26

27 ²³² Ex. No. A-10 at 42.

28 ²³³ See footnote 198, *supra*.

²³⁴ *In the Matter of the Application of Southwest Gas*, Docket No. G-01551A-04-0876, Decision No. 68487 (Feb. 23, 2006).

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